

Donald Trump set to win the US presidential race

What happened?

Republican Donald Trump appears to have scored an upset victory in the race for the White House, upending the political establishment. The businessman had trailed in the polls throughout the campaign but began to close the gap just prior to the election. Undecided voters broke for Trump as he reiterated his criticism of Hillary Clinton and promised to strengthen border controls. Trump overcame Clinton's strength among Latinos with a surge in votes from rural and suburban America. The betting markets gave him just a 25% chance of occupying the White House, suggesting that recent polls once again failed to gauge the depth of opposition to mainstream politics, and dissatisfaction with elements of globalization.

The Republican Party won highly contested Senate seats in Indiana, North Carolina, and Wisconsin, while retaining Senate seats in Florida and Ohio. The party has retained control not only of the upper chamber, but also the House of Representatives, losing fewer seats than expected. It now appears we have a Republican sweep.

While historically a Republican sweep has been one of the most favorable scenarios for US equity markets (with a median annual total return of 15% for the S&P 500 Index, between 1928 and 2014), Trump's win heralds a period of greater uncertainty in US policy. His lack of governing experience, potential difficulties building relationships with congressional leaders, and inconsistent policy pronouncements during the race make it hard to predict his policy initiatives or his effectiveness in driving them through Congress. Some investors have raised concerns that his election would mark a deterioration in global trade relations. During the campaign Trump pledged a tougher stance in trade talks with key trading partners such as Mexico and China as well as a review of US commitments to global security institutions. Trump also promised a clampdown on illegal immigrants, and his policies, if implemented, could cause the US labor force to contract.

How did markets react?

The market reaction to the outcome, in our view, will come in two stages. A reflexive flight to safety has already occurred, with Treasury bond prices rising. The US dollar has declined around 1% on a trade-weighted basis, while safe-haven currencies like the Japanese yen (+2.9%) rallied against USD. And gold also climbed 3.6%. Risk-sensitive assets lost ground – S&P 500 futures fell 4.2%, and the Mexican peso shed 9% against the dollar.

While these first-round effects are certainly disconcerting, we expect the US equity market to recover over the medium term. CIO believes fundamentals will outweigh political uncertainty and US stocks can rebound on the back of accelerating earnings per share (EPS) growth. We forecast EPS to rise from 1% this year to 8% next. Selected industries could benefit from the possibility of more lenient regulation – particularly the financial services and energy sectors. Others businesses, especially those focused on national defense infrastructure, could enjoy advantages from more expansionary fiscal policy. Still, policy uncertainty may raise overall equity-market volatility, and lead to market dislocations that short-term investors might look to exploit.

For fixed income markets, we believe the initial rally in Treasuries will be relatively short lived. The market-implied probability of a December rate hike by the Federal Reserve fell below 50%, from around 82% on the eve of the vote. But longer term, Trump has promised tax cuts without offsetting expenditure reductions. A deteriorating fiscal outlook could push government borrowing costs higher. Markets are already shifting their central bank policy expectations to account for higher US policy uncertainty, and elevated market turbulence.

What are we watching?

The implications of this surprise electoral outcome will take time to unfold. Given Trump's limited background in politics, markets will look toward his appointments for top administrative posts for clues about his policy agenda. The result underlines again the importance of investment diversification, both in terms of regions and asset classes.

While there have been some initial signs of stress in global equity markets, we note that Asian markets outside of Japan have been relatively robust, helped by the weakness of the US dollar and comparative stability of the USDCNY exchange rate. We will watch to see whether a weaker USD and lower US Treasury yields help ease financial conditions in global markets, and offset some of the initial asset price volatility.

In our latest *Global Risk Radar* report (31 October) we outlined a number of global investment ideas in the event of a Trump victory. When markets open in Europe, we will be looking for:

- Eurozone consumer discretionary stocks to underperform the broader market (MSCI EMU), on fears that increased protectionism and a weaker USD will damage the sector's earnings prospects.

When trading begins in the Americas, we expect to see:

- US defense companies outperforming the wider US stock market, as we believe a Trump presidency will boost US military spending.
- US managed care providers in the healthcare sector, by contrast, suffering, as Trump has promised to work on repealing the Patient Protection and Affordable Care Act (known as "Obamacare").
- Mexican assets remain under pressure. We expect the Mexican peso to stay weak against the USD, and Mexican equities to underperform emerging market equities overall (MSCI Emerging Markets). A full 80% of Mexican exports are US bound, and 98% of remittances come from Mexican workers in the US. Trump's proposed curbs on immigration and trade may weaken these important economic ties.

We will give a fuller update in another CIO Note later today. This will touch on the day's market developments worldwide, and examine the potential medium-term economic and investment consequences of a Trump administration.

As usual, please email any comments or questions to ubs-cio-wm@ubs.com.

Best,

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Appendix

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Version 06/2016.

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